Office of Chief Counsel
Internal Revenue Service

memorandum

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EYWu

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to: Carmin Hardy, Team Manager, LMSB:F:1731
Frank Cincotta, International Examiner, LMSB:F:1731
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from: June Y. Bass, Associate Area Counsel (LMSB)
Erica Y. Wu, Attorney (LMSB)

subject: Taxpayer: [redacted]
EIN: [redacted]
Tax Years: [redacted], [redacted]
Issue: I.R.C. §§ 197, 174

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

This memorandum responds to your request dated April 17, 2002. This memorandum should not be cited as precedent.

ISSUE

Whether the fee paid by the Taxpayer to its foreign parent for designing, developing, and improving a new [redacted] is a (1) royalty, (2) acquisition cost for amortizable section 197 intangibles, or (3) research and development expenditure under I.R.C. § 174.

CONCLUSION

The fee is a research and development expenditure under I.R.C. § 174.

FACTS[1]

[redacted] ("[redacted]" or "[redacted]") is a domestic corporation wholly owned by [redacted] ("[redacted]" or "[redacted]"), a [redacted] corporation. [redacted], in turn, is [redacted]% owned by [redacted] ("[redacted]"). [redacted] manufactures [redacted] [redacted] distributes the [redacted] manufactured by [redacted].

In [redacted], [redacted] and [redacted] formed a joint venture to market a new [redacted] (the "[redacted]"). The joint venture called for [redacted] to design and develop, and for a company called [redacted] ("[redacted]") to manufacture and sell, the [redacted]. [redacted] is an [redacted] limited liability company owned by [redacted] and [redacted].

To carry out this joint venture, [redacted] separately entered into an agreement with [redacted] and [redacted]. [redacted] first entered into a license agreement (the "License Agreement") with [redacted]. Under the License Agreement, [redacted] promised to grant [redacted] an exclusive license to the technology necessary for the [redacted] production in exchange for a payment equal to [redacted]'s costs for developing the licensed technology plus a percentage of [redacted]'s sales as royalty. [redacted]'s payment obligation would not rise until the production begins.

Shortly after the License Agreement was executed, [redacted] entered into a development agreement (the "Development Agreement") with [redacted] by which [redacted] agreed to develop the [redacted] for [redacted]. Specifically, [redacted] agreed to (1) design and develop the [redacted] in accordance with [redacted]'s specifications, and (2) modify the [redacted] as necessary to comply with the [redacted] [redacted] in the U.S. (collectively the "Development Work"). [redacted], in return, agreed to pay [redacted] (1) a fee (the "Fee") calculated based on the number of hours spent by [redacted]'s engineers and research personnel in the Development Work, and (2) any out-of-pocket costs. The Development Agreement specifically excluded two costs from the Fee: (1) the costs for producing and supplying prototype [redacted]; and (2) the costs for developing the [redacted] to be supplied to [redacted] [redacted].[2]

With respect to the intellectual property resulting from the Development Work (the "Development Results"), the Development Agreement provides:

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[1] Our understanding of the facts of this case is limited to the facts presented by you. We have not undertaken any independent investigation of the facts of this case. If the actual facts are different from the facts known to us, our legal analysis and our conclusions and recommendations might be different. Accordingly, if you learn that the facts known to us are incorrect or incomplete in any material respect, you should not rely on the opinions set forth in this memorandum, and should contact our office immediately.

[2] [redacted] would recover such costs through the sale of the [redacted] to [redacted] or [redacted]

[redacted]

In a written response to Exam's inquiry concerning the patent ownership, [redacted] states:

[redacted]

Two Memorandums of Understanding between [redacted] and [redacted] executed before the Development Agreement show that the parties intended all the Development Results, including patents, to belong to [redacted].

[redacted] successfully developed the [redacted] for [redacted], allowing [redacted] to begin its production and sale in [redacted].

[redacted] has treated the portion of the Fee actually paid as a research and development expenditure and deducted it under I.R.C. § 174.

DISCUSSION

1. Royalty.

The first issue is whether the Fee is a royalty.

Neither the Code nor the regulations define the term "royalty." However, I.R.C. § 894(a)(1) provides that the Code "shall be applied to any taxpayer with due regard to any treaty obligation of the United States which applies to such taxpayer." Thus, we look to the applicable treaty for guidance, which in this case is the [redacted] (the "Treaty").

The Treaty language, in conjunction with the Technical Explanation, suggests that a royalty is a payment for the use of an intangible property and not a payment for personal services. This definition, in fact, is consistent with the definition adopted by the Service. See Rev. Rul. 81-178 (defining royalty as a payment relating to use of a valuable right such as trademarks, trade names, service marks, copyrights and does not include payments for personal services). Based on the foregoing principles, we do not believe the Fee should be characterized as a royalty because it is the consideration for [redacted]'s services in developing the [redacted] and not for the use of [redacted]'s intangibles.

2. Acquisition Costs for Section 197 intangibles.

The second issue is whether the Fee constitutes an acquisition cost for amortizable section 197 intangibles. If it is, it will be subject to the amortization rule under I.R.C. § 197.

I.R.C. § 197(a) provides that a taxpayer is entitled to an amortization deduction for any amortizable section 197 intangibles. Amortizable section 197 intangibles are any section 197 intangibles that are acquired by the taxpayer after August 10, 1993 (or after July 25, 1991, if a valid retroactive election under Treas. Reg. § 1.197-1T has been made), and held in connection with the conduct of a trade or business or an activity described in section 212. I.R.C. § 197(c)(1); Treas. Reg. § 1.197-2(d)(1). Section 197 intangibles include any formula, process, design, pattern, know-how, format, or other similar items. I.R.C. § 197(d)(1)(C)(iii). They also include any interest in patents and copyrights, but only limited to those that are acquired as part of a purchase of a trade or business. I.R.C. §§ 197(e)(4)(C), 197(d)(1)(C)(iii); Treas. Reg. § 1.197-2(c)(7).

Amortizable section 197 intangibles do not include any self-created section 197 intangibles, except where the intangibles are created in connection with an acquisition of assets constituting a trade or business or substantial part thereof. I.R.C. § 197(c)(2); Treas. Reg. § 1.197-2(d)(2). An intangible is self-created if the taxpayer makes payments or otherwise incurs costs for its creation, production, development, or improvement, whether the actual work is performed by the taxpayer or by another person under a contract with the taxpayer entered into before the contracted creation, production, development, or improvement occurs. Treas. Reg. § 1.197-2(d)(2).

Here, the Fee is not an acquisition cost, but a development cost. The Fee is calculated based on the number of hours spent by [redacted] in the Development Work, not on the projected value of the Development Results. In other words, [redacted] paid for [redacted] s services, not for [redacted] 's property. Given that [redacted] paid the Fee for the Development Work performed by [redacted] pursuant to a contract it entered into before the actual development occurred, any section 197 intangibles resulting from the Development Work would be considered as created by [redacted] under Treas. Reg. § 1.197-2(d)(2). Since there is no indication that the [redacted] was developed in connection with an asset acquisition, none of the Development Results would qualify as an amortizable section 197 intangible.

We understand your inquiry regarding the applicability of section 197 arose from the exclusive patent license [redacted] received from [redacted]. You believe an argument can be made that a portion of the Fee was paid to acquire such license. The patent license, even if acquired, is not a section 197 intangible because the facts do not show that it was acquired as part of a purchase of a trade or business. See I.R.C. § 197(e)(4)(C)

3. I.R.C. § 174

The third issue is whether the Fee is a research and development expenditure under I.R.C.§ 174.

I.R.C. § 174 allows a taxpayer to currently deduct a reasonable amount of research or experimental expenditures that he pays or incurs during the taxable year in connection with his trade or business. I.R.C. §§ 174(a)(1), 174(e). Section 174 applies not only to research or experimental expenditures incurred directly by the taxpayer, but also to situations such as this

case where the expenditures are incurred by a third party conducting the research and experimentation on behalf of the taxpayer. Treas. Reg. § 1.174-2(a)(8).

In this case, there is no question that [redacted] incurred the Fee in connection with a trade or business.[3] The question is whether the Fee is a reasonable research or experimental expenditure. You have verbally indicated to us that you have not questioned the reasonableness of the Fee. Our analysis herein is therefore limited to whether the Fee is a research or experimental expenditure.

Research or experimental expenditures are research and development ("R&D") costs in the experimental or laboratory sense. Treas. Reg. § 1.174-2(a)(1). Expenditures are R&D costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Id. "Product" includes any pilot model, process, formula, invention, technique, patent, or similar property and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease or license. Treas. Reg. § 1.174-2(a)(2).

Whether expenditures qualify as R&D expenditures depend on the nature of the activity to which the expenditures relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents. Treas. Reg. § 1.174-2(a)(1). Generally, R&D expenditures include all the costs incident to the development or improvement of a product. Treas. Reg. § 1.174-2(a)(1). They do not, however, include the acquisition costs for another's patent, model, production or process. Treas. Reg. § 1.174-2(a)(3)(vi). Nor do they include the costs for acquiring or improving land or other depreciable property, irrespective of the fact that the property or improvements may be used by the taxpayer in connection with the research or experimentation. Treas. Reg. § 1.174-2(b)(1).

Here, the Fee relates entirely to the design, development, modification, and improvement of the [redacted]. None of the Fee was used to acquire [redacted]'s intangibles, prototype [redacted], parts, or any depreciable property. Therefore, the Fee is an R&D expense.

You believe the Fee, or a portion thereof, should not be treated as an R&D expense to [redacted] because [redacted] does not own the patents. As we discussed above, any patents resulting from the Development Work would be considered as created by [redacted] under Treas. Reg. § 1.197-2(d)(2). It therefore follows that [redacted] is the owner of its creation. Moreover, the Memorandums of Understandings preceding the Development Agreement, together with the fact that [redacted] would have to pay to use the patents, strongly suggest that the parties have always viewed [redacted] as the

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[3] A well-established line of authorities holds that the exploitation of research results through the sale or license of a patent or other proprietary rights may constitute a trade or business. See Cleveland v. Commissioner, 297 F.2d 169 (4th Cir. 1961); Avery v. Commissioner, 47 B.T.A. 538 (1942); Kilroy v. Commissioner, T.C. Memo 1980-489; Louw v. Commissioner, T.C. Memo 1971-326; Silver v. Commissioner, T.C. Memo 1956-95.

patents' rightful owner. As far as why ISZJ retained the legal title to the patents, we find [redacted]'s explanation reasonable. A [redacted] manufacturer most likely has more experience in administering patents than a [redacted] distributor. Instead of having to transfer the patents to [redacted], and then have [redacted] assign back the patent rights, [redacted] probably decided to simplify the transaction by allowing [redacted] to withhold the legal title. This arrangement, by itself, is not a basis for disallowance under I.R.C. § 174.

This advice has been coordinated with the ISP Counsel for the [redacted], and will be forwarded to the National Office for post-review. If you have any questions, please contact Erica Wu at (949)360-2678.